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No. 26

In the Supreme Court of the United States

OCTOBER TERM, 1932

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HENRY HARMEL

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH ~~DISTRICT~~ circuit

BRIEF FOR THE PETITIONER

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 20) is reported in 56 F. (2d) 153. The opinion of the Board of Tax Appeals (R. 8–10) is reported in 19 B. T. A. 376.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Fifth Circuit was entered February 23, 1932. (R. 21.) Petition for a writ of certiorari was granted April 18, 1932. Jurisdiction is con-

ferred upon this Court by Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether cash bonuses paid as advance royalties under oil and gas leases on lands in the State of Texas constitute income from the sale of capital assets within the meaning of Section 208 of the Revenue Act of 1924.

STATUTE INVOLVED

Revenue Act of 1924, c. 234, 43 Stat. 253, 262:

> SEC. 208 (a) For the purposes of this title—
>
> (1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;
>
> (2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets;
>
> (3) The term "capital deductions" means such deductions as are allowed by section 214 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year;
>
> (4) The term "ordinary deductions" means the deductions allowed by section 214 other than capital losses and capital deductions;
>
> (5) The term "capital net gain" means the excess of the total amount of capital

gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain;

(6) The term "capital net loss" means the excess of the sum of the capital losses plus the capital deductions over the total amount of capital gain;

(7) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(8) The term 'capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections

210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain.

* * * * *

(U. S. C., Title 26, Sec. 939.)

STATEMENT

The respondent is an individual residing at Megargel, Texas. In the year 1924 he was, and had been for many years, the owner in fee simple of certain lands (R. 8) in the State of Texas (R. 2). In October, 1924, he executed two oil and gas leases of such lands for terms of three years and as long as oil or gas should be produced from the land by the lessees on the basis of stipulated royalties measured by the lessees' production of oil and gas and a cash consideration of $57,000. (R. 8, 15, 17.) This cash payment was returned by respondent as gain from sales of capital assets, under Section 208 of the Revenue Act of 1924. (R. 9.) The Commissioner of Internal Revenue treated it as income, taxable at the ordinary rates. (R. 5, 9.) The Board of Tax Appeals held with the Commissioner (R. 10), but the Circuit Court of Appeals for the Fifth Circuit reversed the Board (R. 20–21.)

The two oil leases referred to above are set out in full in the record. (R. 14–19.)

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that cash bonuses paid as advance royalties for the execution of oil and gas leases in

the State of Texas constitute income from the sale of capital assets, within the meaning of Section 208 of the Revenue Act of 1924.

2. In holding that in determining the question presented it was bound by the decisions of the Texas courts that leases of oil lands constitute sales of the oil.

3. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

A cash bonus paid upon the execution of an oil and gas lease is to be treated as advance royalty. The distinction made by the court below between bonus and royalty is unsound and is contrary to the decided cases.

The capital-gains provisions of the statute first appeared in the Revenue Act of 1921. At that time it was settled by the decisions of this Court that royalties are ordinary income and are not to be treated under the Revenue Acts as proceeds from the conversion of capital assets. The statute here involved contains no definition of the term "sale of capital assets" which is decisive. But it is to be presumed that Congress intended to deal only with those transactions which under general law, as it then existed, constituted sales of capital assets. A consideration of the purpose of the legislation supports this conclusion. The classification made in the statute was designed to stimulate "sales" of property which was then being held off the market

because of the burden of taxes theretofore imposed upon "capital gains" accumulated over a number of years and realized upon the "sale" of property which had enhanced in value. Rentals and royalties from oil leases were not within the purpose of the law in reducing taxes upon "capital gains."

The court below erroneously held that decision was controlled by the local rule that such leases as are here involved constitute sales of oil and gas in place. This Court has indicated that local rules may be disregarded in classifying the income from mineral leases, and until the decision below that was thought to be the correct view. It is true that where a Federal statute is so drawn that it either expressly or by necessary implication requires resort to the local law the Federal courts will be guided by the local rule. But that is not the situation here, and the cases relied upon below are therefore distinguishable.

ARGUMENT

I

THE PAYMENTS RECEIVED BY RESPONDENT WERE ADVANCE ROYALTIES

The court below held that the cash bonuses received by respondent under oil and gas leases [1]

[1] These leases were made "for the sole and only purpose of mining and operating for oil and gas and of laying pipe lines and of building tanks, power stations, and structures thereon to produce, save, and take care of said products * * *." (R. 14–15, 17.)

were gains from the sale of capital assets and not ordinary income. This conclusion was based upon its earlier decision in *Ferguson* v. *Commissioner*, 45 F. (2d) 573. In that case a distinction was drawn between a bonus and a royalty, and it was held that the former represented the proceeds from the sale of oil and gas leases, while the latter constituted proceeds from the retained interest of the lessor which came to him from time to time as revenue under the contract.

We are unable to apprehend any sound basis for this distinction. The consideration for the lease is the cash bonus and the future royalties. Apparently the court below was impelled to make the distinction because of a misconception which it entertained as to the scope of the depletion allowance. It assumed that a depletion allowance was not made to the lessor with respect to the bonus, while such an allowance was made with respect to the royalty, so that (p. 577) "this part of his capital is protected and returned." The assumption that no depletion allowance was permitted with respect to the bonus is clearly erroneous. See Article 216, Treasury Regulations 65, as amended by T. D. 3938, V–2 C. B. 117; *Murphy Oil Co.* v. *Commissioner*, now pending in this Court, No. 80, October Term, 1932.

Nor is the distinction made below between a bonus and a royalty supported by the cases cited.[2] In every case which has been found where the question was presented it has been held that a bonus does not differ from a royalty, but, on the contrary, constitutes a part of the royalty which is paid in advance. The leading case on this point is *Work* v. *Mosier,* 261 U. S. 352, where this Court held that a bonus paid for an oil and gas lease on Indian land was (pp. 357–358) "part of the royalty or rental in a lump sum * * *."

The court below distinguished that case by treating it as announcing a rule applicable only to its peculiar facts. But this Court's discussion of the nature of a bonus does not indicate that it was limited to the particular bonus there involved and that other bonuses should be regarded differently. This Court there said (pp. 357–358):

> The bonus which was the result of bidding for desirable and profitable oil and gas leases secured for the members of the Osage Tribe the just value of the use of their property which the fixing of royalties in advance by the President was not adapted to give them. It was in effect a supplement to the royalties already determined. It was really part of the royalty or rental in a lump sum or down payment. We do not see how it can

[2] *Texas Co.* v. *Daugherty,* 107 Tex. 226; *Stephens County* v. *Oil & Gas Co.,* 113 Tex. 160; *Humphreys-Mexia Oil Co.* v. *Gammon,* 113 Tex. 247, 255; *Waggoner Estate* v. *Sigler Oil Co.,* 118 Tex. 509.

> be classified as anything else. It was income from the use of the mineral resources of the land. Of course, it involved a consumption and reduction of the mineral value of the land, but so does a royalty. This is an inevitable characteristic of income from the product of the mine. What was intended to be distributed to the members of the tribe was the income from the mineral deposits in their lands, and the bonus was part of that. Doubtless Congress had in mind regular annual or quarterly equal payments when it used the word royalties; and did not anticipate such large down payments. But in the unexpected event, we must decide under what head the bonus is to be treated, whether as capital or income, and it seems clear to us that, in view of the entire statute, it is more aptly described by the latter term.

We submit that this Court did not reach the conclusion that bonuses were advance royalties because of any peculiar provision of the statute involved, but because they constituted "income from the use of the mineral resources of the land" (p. 358). The question was squarely presented whether a bonus should be classified as capital derived from a disposition of property or as income paid for the use thereof. Under Section 4, Second, of the Osage Allotment Act (34 Stat. 544), it was the "royalty" received from the leases which was to be distributed to the individual members of the tribe. This Court held (p. 358) that "What was

intended to be distributed to the members of the tribe was the income from the mineral deposits in their lands, and the bonus was part of that." The statute did not make the classification, and this Court, in accordance with general principles of law, held that such bonus was not capital, but income.

The controlling authority of *Work* v. *Mosier, supra,* has been uniformly recognized wherever the distinction between bonus and royalty was sought to be made. *Alexander* v. *King,* 46 F. (2d) 235 (C. C. A. 10th), certiorari denied, 283 U. S. 845; *W. M. Ferguson* v. *Commissioner* (C. C. A. 10th), decided June 30, 1932, reported in 323 C. C. H. 9062; *Appeal of Nelson Land & Oil Co.,* 3 B. T. A. 315, 326. The court below stands alone in making a distinction between bonus and royalty. It is not made in the following cases, which do not cite *Work* v. *Mosier: Burkett* v. *Commissioner,* 7 B. T. A. 560, affirmed, 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565; *Berg* v. *Commissioner,* 33 F. (2d) 641 (App. D. C.), certiorari denied, 280 U. S. 598; *Hirschi* v. *United States,* 67 C. Cls. 637, certiorari denied, 280 U. S. 576. The latter case also dealt with an oil lease of Texas lands, and its decision is squarely opposed to the instant decision.

Support for the view that a bonus is to be treated as an advance royalty is also to be found in the decision of this Court in *United States* v. *Biwabik Mining Co.,* 247 U. S. 116. The distinction between bonus and royalty was not there in issue, but the

Court tacitly assumed that they were not different and treated them alike, quoting from the opinion of the District Court as follows (p. 121):

> The defendant paid $612,000 for the lease under consideration and in addition assumed the payment of the royalties stipulated for therein. This may properly and justly be considered a payment in advance of an increased royalty on ore to be mined, and that is precisely the character which the defendant gave to the payment when dealing with it in its private accounts * * *.

Our contention that a bonus is advance royalty is also supported by decisions in cases where lessee taxpayers have sought to deduct the entire bonus (under leases other than oil leases) as a business expense in the year in which paid. It has uniformly been held in such cases by the Bureau of Internal Revenue,[3] by the Board of Tax Appeals,[4] and

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[3] Article 109, Treasury Regulations 45 and 62; Article 110, Treasury Regulations 65 and 69; Article 130, Treasury Regulations 74; I. T. 1711, II–2 C. B. 104; A. R. R. 6459, III–1 C. B. 138.

[4] *Nelson Land & Oil Co.*, 3 B. T. A. 315, 325–326; *Burkett* v. *Commissioner*, 7 B. T. A. 560, affirmed, 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565; *Hazlett* v. *Commissioner*, 10 B. T. A. 332, 337; *Parkey* v. *Commissioner*, 16 B. T. A. 441, 445; *Baton Coal Co.* v. *Commissioner*, 19 B. T. A. 169, affirmed, 51 F. (2d) 469, (C. C. A. 3d), certiorari denied, 284 U. S. 674; *Ferguson* v. *Commissioner*, 20 B. T. A. 130, 131, reversed, 45 F. (2d) 573 (C. C. A. 5th). Cf. *Waggoner* v. *Commissioner*, 24 B. T. A. 657.

by the courts[8] that such a bonus is advance rental or royalty and that the deduction must be taken over the life of the lease.

II

SINCE A BONUS IS ADVANCE RENTAL OR ROYALTY, THE PAYMENTS RECEIVED BY RESPONDENT SHOULD BE CLASSIFIED AS ROYALTIES AND RETURNED AS ORDINARY INCOME

This Court has repeatedly held that royalties from oil and gas leases are not to be treated under the Revenue Acts as proceeds from the conversion of capital assets. In 1913 this Court held in *Stratton's Independence* v. *Howbert*, 231 U. S. 399, that the profit realized from mines by operating owners was income within the meaning of the excise tax laid upon corporations and measured by their income. Section 38, Act of August 5, 1909, c. 6, 36 Stat. 11, 112. This conclusion was reaffirmed in 1918 in *Goldfield Consol. Mines Co.* v. *Scott*, 247 U. S. 126. In 1916 the same conclusion was reached in *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 114,

[8] *Central Nat. Bank of Tulsa, Okla.*, v. *United States*, 283 Fed. 368, 373 (C. C. A. 8th), dismissed, 264 U. S. 600; *J. Alland & Bro. Inc.* v. *United States*, 28 F. (2d) 792 (Mass.); *Hirschi* v. *United States*, 67 C. Cls. 637; *Burkett* v. *Commissioner*, *supra*; *Baton Coal Co.* v. *Commissioner*, *supra*; *Galatoire Bros.* v. *Lines*, 23 F. (2d) 676 (C. C. A. 5th). See *Constantine* v. *Wake*, 1 Sweeny 239, 244 (N. Y.); Klein, Federal Income Taxation, p. 439; *Crile* v. *Commissioner*, 55 F. (2d) 804 (C. C. A. 6th). Cf. *Jennings & Co. Inc.* v. *Commissioner*, 59 F. (2d) 32 (C. C. A. 9th).

under the income-tax section of the Tariff Act of October 3, 1913, c. 16, 38 Stat. 114, 166, 181.

While *Stratton's Independence* v. *Howbert* and *Stanton* v. *Baltic Mining Co.* related to the income of operating owners, the same rule was applied to lessors in 1917 in *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, where it was held that royalties received by lessors of iron-ore land constituted income under the 1909 Act and not payments for the sale of ore. The principle of the *Sargent Land Co. case* was applied to a lessee in 1918, and the receipts from a similar lease were held to be taxable income. In *United States* v. *Biwabik Mining Co., supra,* with respect to the rights of the lessee under the lease, it was said (pp. 125–126):

> The lessee takes from the property the ore mined, paying for the privilege so much per ton for each ton removed. He has this right or privilege under the form of lease here involved so long as he sees fit to hold the same without exercising the privilege of cancellation therein contained. He is, as we held in the *Sargent Land Co. Case,* in no legal sense a purchaser of ore in place.

While *Stratton's Independence* v. *Howbert* arose under the 1909 Act, "income" has the same meaning in the Revenue Acts passed since the adoption of the Sixteenth Amendment. *Merchants' Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509, 519; *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, 335.

When the capital gains provisions first appeared in the Revenue Act of 1921 (c. 136, 42 Stat. 227), it was then regarded as settled law that mining leases did not convey title to the ore in place. See *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 371,[6] and *Ewert* v. *Robinson*, 289 Fed. 740, 747[7] (C. C. A. 8th).

It was also then settled in several of the oil-producing States that, although the proprietor of the surface could bore wells for the purpose of extracting gas and oil, he had no title whatever to them as owner until the gas and oil were actually reduced to possession.[8] At the same time it was

[6] In this case the Court said (p. 371): "It was held in both cases [*Von Baumbach* v. *Sargent Land Co.* and *United States* v. *Biwabik Mining Co.*, *supra*], as we hold here, that the leases under consideration did not convey title to the ore in place."

[7] The court here said (p. 747): "We are not dealing here with the question of whether such leases are a grant of the oil and gas or mineral within the ground. It is settled by the decisions of the Supreme Court before referred to that they are not."

[8] *Ohio Oil Co.* v. *Indiana* (No. 1) (1900), 177 U. S. 190; *The State* v. *The Ohio Oil Co.* (1898), 150 Ind. 21, 32; *Louisville Gas Co., &c.*, v. *Kentucky Heating Co.* (1909), 132 Ky. 435, 442; *Rich* v. *Doneghey* (1918), 71 Okla. 204; *Frost-Johnson Lumber Co.* v. *Salling's Heirs* (1920), 150 La. 756; *Watford Oil & Gas Co.* v. *Shipman* (1908), 233 Ill. 9; *Wagner* v. *Mallory* (1902), 169 N. Y. 501, 505; *Kelley* v. *The Ohio Oil Co.* (1897), 57 Ohio 317, 328. The question had not been definitely determined in the States of Tennessee, Kansas, Arkansas, Pennsylvania, California, and West Virginia. 1 Tex. Law Review, 163, 170–178.

practically a universal rule that the lessee under a lease which grants, leases, and lets the realty for the sole purpose of mining and operating for oil and gas, and producing and saving such products, acquired no title to such oil and gas until it was reduced to possession. Thornton, Oil and Gas (4th Edition), Sections 36, 57. This was likewise the rule in Texas (*Young* v. *Jones*, 222 S. W. 691), although a change occurred in 1923 by the decision of the Supreme Court of Texas in *Stephens County* v. *Oil & Gas Co.*, 113 Tex. 160.*

The section of the statute here involved does not indicate any intent to depart from this well-established rule. On the contrary, applying well-settled principles of construction, Congress is presumed to have legislated with the settled principles applicable to mineral leases in mind (*United States* v. *Merriam*, 263 U. S. 179, 187), and must be presumed to have used the term "sale" in its usual, ordinary, and every-day meaning (*Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 561). It is not to be presumed that Congress used the word in a sense not applicable to oil and mining leases under established law and usage recognized and declared by the decisions of the courts. Since a lease like the

* *Texas Co.* v. *Daugherty*, 107 Tex. 226, 234, decided in 1915, was generally understood as resting upon the form of the "lease" in that case, which was in terms a conveyance of the oil and gas in place. 18 Mich. Law Review, 757. *Jones* v. *Murphy* (1923), 253 S. W. 634, did not apply the rule of *Texas Co.* v. *Daugherty*.

one involved in the case at bar was understood at the time of the enactment of the law as a lease and not as a conveyance, Congress could not have intended that such a lease should be comprehended within the meaning of the term "sale."

In *Burkett* v. *Commissioner, supra,* dealing with the same question here involved under the similar provisions of the Revenue Act of 1921, the court said (p. 668):

> Whether this instrument [an oil and gas lease in Arkansas] can be described by any defined legal terms—such as lease, license, etc.—it is certain that it is only a limited grant of a right in respect to land and for a limited period of time by one having the fee and possession. Such can not be denominated a sale in the ordinary sense of that word, and there is no reason to construe section 206 as using "sale" in any other sense. The wording and the legislative history of section 206 are clear that it was intended to apply to "sales" in the sense of *conveyance of title to property,* not the *creation of privileges or estates or rights in property for a limited period of time.*

The purpose of Congress in enacting the provisions as to gains arising from the sale of capital assets indicates that the construction for which we contend is correct. Prior to 1921 gains and profits representing the increased value of property were taxed as a lump sum in the year in which the property was sold and the gain realized. Thus,

although this property represented the realization of a gradual appreciation of value extending over several years, the effect of the statute was to concentrate the gain and the tax in a single year. The profits often reached the upper surtax brackets and became subject to high rates of taxation. Consequently, the specter of the tax had the effect of inducing the owners of such property to withhold it from sale. The capital-gains provisions were adopted to relieve this situation. See *Alexander* v. *King,* 46 F. (2d) 235 (C. C. A. 10th), certiorari denied, 283 U. S. 845.[10]

The Revenue Act of 1924 continued the provision of the 1921 Act with respect to the tax upon the sale of capital assets, but, although some modifications were made,[11] there is no indication in the legislative history of an intent to bring oil and gas leases within its provisions.

The statute does not define the term "sale"; "capital assets" is defined generally, with exceptions not here pertinent, as property held by the taxpayer for more than two years. (See Section 208 (a) (8), *supra,* p. 3.) But definition is not necessary in order to determine a question of classification where the purpose of Congress is reasonably clear. *Bowers* v. *Lawyers Mortgage Co.*, 285

[10] See H. R. 350, 67th Congress, 1st Session, pp. 10–11.

[11] H. R. 179, 68th Cong., 1st Sess., pp. 19–20; S. R. 398, 68th Cong., 1st Sess., pp. 21–22; Conference Report No. 844, to accompany H. R. 6715, 68th Cong., 1st Sess., p. 15.

U. S. 182, 187. There can be no doubt that the sole purpose of Congress was to encourage the "sale" of property which was being held off the market on account of the tax situation.

The term "sale of capital assets" aptly describes the transfer of property whereby the owner parts with his entire interest for a consideration. The term does not describe a lease under which the lessor retains an interest in the land. The owner of oil lands needed no encouragement from the statute to lease his lands, for there could be no capital gain realized from the enhanced value of the property subject to tax. The tax fell only upon the income in the form of a bonus and royalties when received under the lease. The owner was deterred by the existing statutes (prior to the Revenue Act of 1921) from selling his land and thus realizing a capital gain, not from leasing his lands and receiving income in the form of rent or royalties. In view of the purpose of Congress to encourage "sales" resulting in the realization of capital gains, the statute should not be construed to cover transactions not within its purpose or within its meaning under the law at the time of its enactment.

It is a familiar rule of statutory construction that the terms used by Congress must be read in the light of, and in an endeavor to effectuate, the objects and purposes for which the statute was enacted, and that to this end the condition of affairs which led to the legislation may be considered.

American Tobacco Co. v. *Werckmeister,* 207 U. S. 284, 293. This principle of construction is not impaired by the rule that doubts in taxing statutes are to be resolved against the Government. The question here is not whether the gain from the transaction is embraced within the taxing statute; it is whether respondent is entitled to a more favorable rate than if the transaction were treated as Congress must have intended it to be in view of the considerations stated above. Thus, the situation is analogous to that where an exemption from taxation is claimed. In such cases the rule requires that the taxpayer be held liable for the tax unless clearly shown to be within the more favored class. *Bowers* v. *Lawyers Mortgage Co., supra.* Moreover, as was said in *Baltimore Talking Board Co.* v. *Miles,* 280 Fed. 658 (C. C. A. 4th), certiorari denied, 259 U. S. 587, before a doubtful statute may be given a construction favorable to the taxpayer (p. 661) "the doubt as to the meaning of the statute must be one which remains after all recognized rules for ascertaining its meaning have been tried." We believe that in holding that the construction of this statute was controlled by State decisions the court below disregarded the principles of construction to which we have referred in this part of the argument, and also certain other established principles which we discuss under the succeeding point.

III

THE STATUTE DOES NOT MAKE ITS APPLICATION DEPENDENT UPON STATE RULES AS TO THE EFFECT OF OIL LEASES BETWEEN THE PARTIES THERETO, AND THEREFORE SUCH STATE RULES MUST BE DISREGARDED IN APPLYING THE STATUTE

Until the decision of the court below in *Ferguson* v. *Commissioner, supra,* 45 F. (2d) 573, the decision of this Court in *Von Baumbach* v. *Sargent Land Co., supra,* 242 U. S. 503, was generally accepted as decisive that the State law defining the effect of a mining lease need not be followed in determining whether the consideration received under such lease constituted income or proceeds from the sale of capital assets under the Federal revenue laws. *Rosenberger* v. *McCaughn,* 25 F. (2d) 699 (C. C. A. 3d), certiorari denied, 278 U. S. 604; *Bankers Pocahontas Coal Co.* v. *Commissioner,* 55 F. (2d) 626 (C. C. A. 4th), now pending in this Court on petition for a writ of certiorari, No. 104, October Term, 1932; *Hirschi* v. *United States, supra,* 67 C. Cls. 637, certiorari denied, 280 U. S. 576. See also *Jamison Coal & Coke Co.* v. *Commissioner,* 24 B. T. A. 554, 570.

In *Von Baumbach* v. *Sargent Land Co., supra,* the Government contended, in part, that the established law of the State with respect to the character of a mining lease should be followed.[12] But this Court said (pp. 518–519):

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[12] The State law did not treat such leases as sales. The Circuit Court of Appeals had applied the Pennsylvania rule that such leases constituted sales. Its decision was reversed. (242 U. S. 517.)

> Ordinarily, and as between private parties, there is no question of the duty of the federal court to follow these decisions of the Minnesota Supreme Court, as a rule of real property long established by state decisions. *Kuhn* v. *Fairmont Coal Company,* 215 U. S. 349, 360. Whether in considering this federal statute we should be constrained to follow the established law of the State, as is contended by the Government, we do not need to determine. The decisive question in this case is whether the payments made as so-called royalties amount to income so as to bring such payments within the scope of the Corporation Tax Act of 1909. The prior decisions of this court in *Stratton's Independence* v. *Howbert,* 231 U. S. 399, and *Stanton* v. *Baltic Mining Company,* 240 U. S. 103, in which the *Stratton Case* was followed and approved, are decisive of this question.

In *Rosenberger* v. *McCaughn, supra,* which arose under the law of Pennsylvania, where a lease of coal lands is treated as a sale of coal in place, the court said (p. 701):

> Wholly aside from the construction which the Minnesota courts had placed upon instruments of that kind and solely because of the nature of the payments themselves, the Supreme Court, as we read its opinion [in *Von Baumbach* v. *Sargent Land Co.*] held that the instrument there in question did not effect a sale of the property * * *.

In *Bankers Pocohontas Co.* v. *Commissioner, supra,* which arose under the law of West Virginia, where the local rule was not clearly established but was assumed to be similar to the Pennsylvania rule, the court, in following the *Rosenberger* case, said that in that case (p. 629)—

> it was pointed out that in *Von Baumbach* v. *Sargent Land Company, supra,* the Supreme Court had reached the conclusion that royalties from mines constituted taxable income wholly aside from the construction placed by the Minnesota courts upon mining leases. The Supreme Court declined to review this interpretation of its decision when it denied certiorari.

In *Hirschi* v. *United States, supra,* which arose under the law of Texas, and presented the identical question involved in the instant case, the Court of Claims, in reliance upon the rule in the *Von Baumbach case* held that a cash bonus paid to a lessor of Texas oil lands was not "a capital gain" but "ordinary income."

Even if the decisions which have treated the conclusion of this Court in the *Von Baumbach case* as deciding that local rules as to the nature of mineral leases do not control in the construction and application of the Federal Revenue Acts are laid aside and the question is to be considered as still open, we believe that there is no basis for treating the peculiar rules applied to oil leases by the Texas courts as requiring a special and unusual construc-

tion of the statute when applied to the consideration paid therefor. If the income from an oil and gas lease is to be classified as capital gain when the transaction takes place in Texas but as ordinary income when the transaction occurs in any other State, it is at once apparent that Texas taxpayers will be favored in a way not contemplated by Congress. It is reasonable to suppose that Congress intended the statute to be uniformly applied, since the desirability of the uniform application of Federal statutes is generally recognized. *Calhoun Gold M. Co.* v. *Ajax Gold M. Co.*, 182 U. S. 499, 505; *United States* v. *Childs*, 266 U. S. 304, 309; *Burk-Waggoner Oil Assn.* v. *Hopkins*, 269 U. S. 110; *Weiss* v. *Wiener*, 279 U. S. 333; *Boston & Maine R. R.* v. *United States*, 265 Fed. 578 (C. C. A. 1st), certiorari denied, 255 U. S. 577; *Eagan* v. *Commissioner*, 43 F. (2d) 881, 883 (C. C. A. 5th. Especially is this true where the rights involved arise under the laws or Constitution of the United States. Under such circumstances it is well settled that the Federal courts are not bound by local law. *Crescent Live Stock Co.* v. *Butchers' Union*, 120 U. S. 141, 159; *Guffey* v. *Smith*, 237 U. S. 101, 114. See also *Black & White Taxicab Co.* v. *Brown & Yellow Taxicab Co.*, 276 U. S. 518. This rule has often been applied in tax cases.[13]

[13] *Fidelity-Philadelphia Trust Co.* v. *Commissioner*, 47 F. (2d) 36, 38 (C. C. A. 3d); *First Nat. Bank in Dallas* v. *Commissioner*, 45 F. (2d) 509 (C. C. A. 5th), certiorari denied, 283 U. S. 845; *Osburn California Corp.* v. *Welch*, 39 F. (2d) 41 (C. C. A. 9th), certiorari denied, 282 U. S.

From an examination of the decisions of this Court we take it to be well settled that the interpretation of a Federal tax statute is quite beyond the reach of local rules unless it is so drawn as to make its application dependent on peculiar incidents and characteristics of property which are necessarily determined by State law. If the application of the Federal statute is made dependent upon such conditions, either expressly or by implication, then necessarily the Federal courts in applying it must look to the local rule of the State to determine those characteristics. *Rosenberger* v. *McCaughn,* 25 F. (2d) 669 (C. C. A. 3d), certiorari denied, 278 U. S. 604. Such was the situation in *Crooks* v. *Harrelson,* 282 U. S. 55; *Poe* v. *Seaborn,* 282 U. S. 101; *United States* v. *Cambridge Loan & Bldg. Co.,* 278 U. S. 55; and *Tyler* v. *United States,* 281 U. S. 497.

In *Crooks* v. *Harrelson, supra,* where a Federal statute imposed a tax upon the transfer of the net estate of a decedent "To the extent of the interest therein of the decedent at the time of his death which after his death is subject to the payment of the charges against his estate and the expenses of

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850; *California Iron Yards Co.* v. *Commissioner,* 47 F. (2d) 514, 516 (C. C. A. 9th); *Aldridge* v. *United States,* 64 C. Cls. 424; *White* v. *Hornblower,* 27 F. (2d) 777 (C. C. A. 1st); *Hart* v. *Commissioner,* 54 F. (2d) 848 (C. C. A. 1st). Cf. *St. Louis Union Trust Co.* v. *Burnet* (C. C. A. 8th), decided May 18, 1932, 323 C. C. H. 8817, 8820.

This rule is also recognized by the Texas courts. *Staley* v. *Vaughn,* 50 S. W. (2d) 907 (Tex. Civ. App.).

its administration and is subject to distribution as part of his estate," only the local law could determine whether the property in question was subject to the payment of charges against the estate and the expenses of its administration, and resort was accordingly had to the local law because the Federal statute was so drawn as to make it necessary.

In *Poe* v. *Seaborn, supra,* and the other community property cases relied upon by the court below, the statute imposed a tax "upon the net income of every individual." This Court held that the word "of" denoted ownership, and since the statute furnished no other standard of determining whether income belonged to an individual, resort was necessarily had to the State law to determine whether the wife also had an ownership in the income there involved. The same problem was presented in *United States* v. *Robbins,* 269 U. S. 315, and *United States* v. *Malcolm,* 282 U. S. 792.

In *United States* v. *Cambridge Loan & Bldg. Co., supra,* the exemption in the Revenue Acts of "domestic building and loan associations" was held to require reference to the local law, and this Court said (p. 59):

> The statutes speak of "domestic" associations, that is, associations sanctioned by the several States. They must be taken to accept, with the qualifications expressly stated, what the States are content to recognize, unless there is a gross misuse of the name.

Tyler v. *United States, supra,* is similarly distinguishable. In *Bankers Pocahontas Coal Co.* v. *Commissioner, supra,* the court said (p. 630):

> Reference is made to *Tyler, Adm'r,* v. *United States,* 281 U. S. 497; *Crooks, Col.,* v. *Harrelson,* 282 U. S. 55; and *Poe, Collector,* v. *Seaborn,* 282 U. S. 101; but it is obvious that each of these decisions turned upon the fundamental question whether the property sought to be taxed came within the purview of the taxing statutes. When it was clear that such was the case, the federal statute was given effect, as in *Tyler* v. *United States,* 281 U. S. 497 * * *.

The court below, however, seemed to think that it was required to follow the State law in the instant case because of this Court's decision in *Group No. 1 Oil Corp.* v. *Bass,* 283 U. S. 279. It is submitted, however, that that case is distinguishable. There the income was that of a lessee, derived from the sale of oil and gas produced under leases of public lands executed under the laws of the State of Texas. Under the Constitution of the State of Texas such public lands could only be disposed of by sale. (See 283 U. S. at p. 281.) Immunity from the tax was claimed on the ground that the income was derived from an instrumentality of the State. On the other hand, the Government contended in part that since under Texas law, as between the State and lessee, the lessee was a purchaser and the lease constituted a sale, the

tax did not fall on the State or an instrumentality of the State but upon a private enterprise. It became necessary, therefore, to determine what was the actual fact as to the ownership of the property which produced the income.[14] If it was in fact the property of the State it was constitutionally immune from the tax. If it was in fact the property of the lessee there was no immunity. As was said in *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393, 399, the reason for resort to State law in the *Group No. 1 Oil Corp. case* was because the "status of the title was matter for determination under the laws of the State as construed and applied by her courts."[15] In those cases the decision depended

[14] In this respect the *Group No. 1 Oil Corp. case* is like *Poe* v. *Seaborn*, *supra*.

[15] In the Government's brief in *Group No. 1 Oil Corp.* v. *Bass*, *supra*, the reasons for applying local law to that case, while it would be inapplicable to a case like *Hirschi* v. *United States*, *supra* (which is precisely like the present case), are stated as follows:

"* * * We are aware of the rule that in applying a Federal taxing statute this Court is not bound by the construction of a local court but is free to make its own interpretation of the nature of any instrument under consideration. *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 518–519; *Burk-Waggoner Assn.* v. *Hopkins*, 269 U. S. 110, 114; *B. & W. Taxi. Co.* v. *B. & Y. Taxi. Co.*, 276 U. S. 518, 530. This principle is applicable in situations analogous to those in *Hirschi* v. *United States*, 67 C. Cls. 637, certiorari denied, 280 U. S. 576, and *Burkett* v. *Commissioner*, 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565, where the controversy turned upon whether or not the taxpayers' incomes were within the terms of the Federal taxing statute there in question. On the other hand, however,

on the relationship that the particular State bore to the land from which the income was derived. So far as the United States was concerned, that was a question between "private parties" in the decision of which local law controls. Cf. *Von Baumbach* v. *Sargent Land Co., supra.* If under the local law the State had sold its property to others, it was held that the effect of a Federal tax upon the income of the purchaser could be disregarded, while the contrary was held if the State retained a proprietary interest.

There is no question here of determining the relation between the State of Texas and a lessee with which it contracted. This case is concerned with a lease made between private parties, and the question is not whether a Federal tax imposes an unconstitutional burden upon the State, but merely whether the income produced by the lease is to be put in one class or another. The classification is made by a Federal statute. The power of Congress to make a classification satisfactory to itself without regard to State law must be conceded, and

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where the point in controversy relates to property rights as between two contracting parties, the rule of the local court will be followed in the Federal courts. *Von Baumbach* v. *Sargent Land Co., supra; Waggoner Estate* v. *Wichita County*, 273 U. S. 113, 117. Accordingly, so far as the relationship between petitioner and its lessor is concerned, the interpretation of the Texas court is deemed to be controlling."

we are concerned only with the intention and purpose of the statute.

Unlike the statutes involved in the cases where resort was had to the local law, Congress has not indicated any purpose that the classification of "ordinary income" and "capital gains" should depend upon local law. General terms are used which are well understood. Reference to local law is not necessary to enable the taxing authorities or the courts to determine where the tax falls, for the criteria necessary to decision are all established by the statute when read in the light of the decisions of this Court cited *supra*, pp. 12–14. Treatment of the bonus received by respondent as "ordinary income" instead of "capital gain" leads to no conflict between Federal law and State law. On the contrary, such conclusion is predicated upon a Federal statute which, in the absence of any indication of a purpose that the incidence of the tax should vary with artificial variations of the local laws of the various States, must be held to contain its own criteria based upon familiar rules established by this Court. Accordingly, we think that the local rule must be disregarded as was done in *Weiss* v. *Wiener*, 279 U. S. 333; *Burk-Waggoner Oil Assn.* v. *Hopkins*, 269 U. S. 110.

In *Weiss* v. *Wiener, supra*, a Federal statute granting a deduction of "a reasonable allowance for the exhaustion, wear and tear of the property used in the trade or business" was involved. Wiener was a lessee and sought an allowance for de-

preciation of property held under a ninety-nine-year lease, renewable forever, which under the local law was treated as in many respects like a conveyance of the fee. The deduction was denied, and this Court refused to follow the local law, saying (p. 337):

> It does not matter that in Ohio, where the properties lie, these long leases are treated as in many respects like conveyances of the fee. The Act of Congress has its own criteria, irrespective of local law, that look to certain rather severe tests of liability and exemption and that do not allow the deductions demanded whatever the lessees [leases] may be called.

In *Burk-Waggoner Oil Assn.* v. *Hopkins, supra,* it was sought to tax as a corporation a joint-stock association which, under the law of Texas, was not recognized as a legal entity but was deemed to be a partnership. The Federal statute did not define the term "joint-stock association" but simply classified such an organization as a corporation. This Court said (p. 114):

> It is true that Congress can not convert into a corporation an organization which by the law of its State is deemed to be a partnership. But nothing in the Constitution precludes Congress from taxing as a corporation an association which, although unincorporated, transacts its business as if it were incorporated. The power of Congress so to tax associations is not affected by the fact

> that, under the law of a particular State, the association can not hold title to property, or that its shareholders are individually liable for the association's debts, or that it is not recognized as a legal entity. Neither the conception of unincorporated associations prevailing under the local law, nor the relation under that law of the association to its shareholders, nor their relation to each other and to outsiders, is of legal significance as bearing upon the power of Congress to determine how and at what rate the income of the joint enterprise shall be taxed.

In the decision in the *Ferguson case, supra,* 45 F. (2d) 573, 575, reference is made to the collection of stamp taxes upon oil leases in the State of Texas under the provisions of the Revenue Act of 1921 (Schedule A, 6, Title XI) and the corresponding provisions of the Revenue Act of 1924 (Schedule A, 5, Title VIII, U. S. C., Title 26, Sec. 901). It is said to be inconsistent to classify these leases as "conveyances * * * whereby any lands, tenements, or other realty sold shall be granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser or purchasers * * *," and at the same time to deny that such leases are sales of capital assets. Article 29 of Regulations 55 provides as follows:

> What constitutes "lands, tenements, or other realty" is determinable by the law of the State in which the property is situated. Standing timber is ordinarily held to be real estate, and where so held the deed transferring it is subject to the tax.

Since oil and gas leases are treated by the Texas decisions as conveyances of real estate, the stamp tax was properly collected unless the provision of the regulations that the local law controls is erroneous. The regulations with respect to capital gains do not purport to make the local law applicable, and whether Regulations 55 properly construes the stamp-tax statute is not in question here. Putting the Texas decisions aside, it is still true that even though an oil and gas lease does not amount to a conveyance of the oil and gas in the ground, it does amount to a conveyance of an interest in the land. *Ewert* v. *Robinson,* 289 Fed. 740, 750 (C. C. A. 8th). This Court is not now called upon to decide whether the stamp tax was properly collected, and if the Treasury Department has been inconsistent and the distinction which has been made is unsound, that should not prevent the application of the correct rule in the present case.

CONCLUSION

It is respectfully submitted that the decision of the court below should be reversed.

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